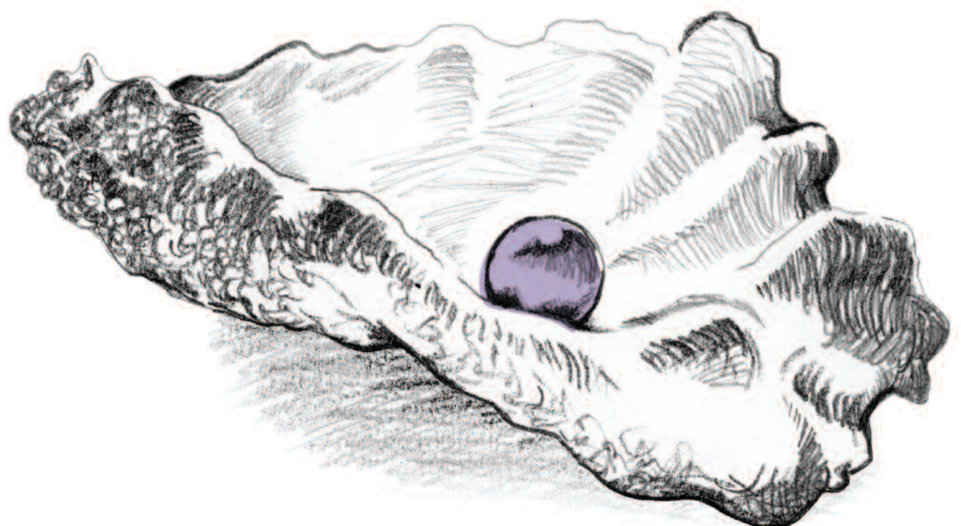
Grant Thornton

Credit where credit's due? What really constitutes 'value' in the UK listed market.

Hidden Gems Index 2007/08



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Introduction

Welcome to the seventh annual Hidden Gems Index, which highlights UK FTSE All Share companies whose share price does not reflect the strength of their cash flow characteristics.

The current business climate has been gripped by the credit crunch, a situation that may be exacerbated by a further contraction in lending or manifested by a downward correction in business volumes and values. In these times, it is those businesses with strong cash flow that may be best equipped to withstand the bumpy economic conditions ahead.

Yet Grant Thornton's 2007/8 Hidden Gems Index (HGI) points to the existence of other barriers, preventing companies from achieving their full stock market value because of their relative size, sector or liquidity.

Often the only time these companies achieve recognition is when they are threatened with acquisition. In previous years, many companies highlighted in the HGI were later subject to acquisition or bid speculation. The companies in this situation faced a risk of takeover, potentially by overseas predators looking for a relatively inexpensive foothold in the UK or Europe or latterly private equity groups. Even more recently hedge funds have taken an interest, as have day traders playing on the volatility of the share price. This becomes a major distraction for management.

Many Top 50 Hidden Gems company executives have kindly commented in this report on the important activities influencing a company's share valuation. These include: working through analysts' models in detail with the analyst to avoid wrong assumptions; actively building up channels of communication with the investment community other than analysts such as the financial and sector press, regulatory bodies; assessing your valuation corridor and anticipating where the share price is heading outside of the corridor to avoid over-corrections later. The executives also highlight areas which in their view may be overlooked. The extent and quality of analyst coverage appears to be an issue with many Hidden Gems companies.

Given the uncertainties facing the UK equity market in 2008, arguably, this is an important period for companies to focus on and demonstrate what actually constitutes value.

David Maxwell
Partner

Executive summary

The 2007/8 Hidden Gems Index (HGI) shows a return to the basis of earlier analyses: smaller companies are more prevalent, with 32 new entrants in the Top 50. These 50 companies created £80 billion in shareholder value over the past 12 months (to 29 January 2008), compared with a fall of £170 billion for the FTSE All Share in the same period. Despite this gain, this group remains significantly unrecognised by the UK stock market. For the past six years, the Top 50 Hidden Gems have outperformed the FTSE All Share market by an average of 6.7%.

In 2006, the analysis identified three main groups of companies: large caps with issues, mid-caps in recovery and 'hidden' small caps. The 2007/8 analysis contains fewer of the large cap grouping as a function, we suspect, of the stock market's strength in early 2007. However, the Top 50 continues to reflect companies such as BSkyB, British Airways and Yell, all of which are facing issues that have compromised their share prices. Equally, the preponderance of mid-caps in recovery has reduced in this analysis. While companies such as Charter, making a return after a strong 2006/7, are shown within the Top 50, companies capitalised at between £850 million and £1.5 billion are more scarce than before. Indeed, this market cap range is dominated by oil & gas companies whose participation is determined by the glass ceiling for ratings on which we commented in 2006.

The HGI analysis consistently shows that companies highly ranked within the analysis have to make a more concerted effort in raising capital market profile than their larger or more highly rated peers. This year, the analysis has assessed the extent to which the Top 50 are covered by sector analysts within banks or brokers. The results are compelling. On average, the Top 50 Hidden Gems attract half of the available analyst coverage within each sector represented. Further analysis shows that there is a strong positive correlation between the number of analysts and the rating awarded to cash flow.

Previous HGI reports suggested that companies within the analysis might consider presenting directly to the investing institutions in order to raise profile rather than rely on the analyst community. While this is still the case, it would be wrong to ignore the apparent resurgence of the small to medium company broker over the last two years.

While bid activity in 2008 could be constrained by the credit-induced market turbulence, we believe that the search for value will continue to trend towards cash flow. Indeed, given the tightening in credit markets, we suspect that equity market analysis could move closer to a cash flow based model, potentially gaining parity with the more established earnings constructs.

Grant Thornton believes that companies can influence their value by re-focusing their marketing efforts to include the investment community. Furthermore, we identify the following points, based on successful practice, case studies and examples shown later in this report:

1. Spend time with analysts and their models to ensure they properly reflect the drivers of your business. Details matter
2. Sector specialism is important in your analyst cover. Make sure you engage those who understand your sector. With less than average cover it is difficult to keep the market informed, so it is important to increase the number of followers and use alternative channels such as the financial and sector press, networks and regulatory bodies, to get your profile and performance across to the market
3. Understand the investment community – actively target investment funds whose selection criteria may more closely fit the future performance of the company
4. Keep shareholders informed of developments directly, instead of waiting for the equity market to tell them
5. Review, and compete with, best practice reporting
6. Continually monitor your share price in the context of a sensible value range and anticipate inevitable over-corrections outside of this corridor
7. Prepare a defence document that addresses the key fundamentals of the business and explains the reasons for continued independence. This is a good way to focus on what really matters
8. Recognise that aspects of brand value and strength are not always fully reflected by analysts

Hidden Gems Index 2007/8 Top 50
(ranked by sector weighting)

HGI Rank	Company	Sector	Market value £ m	Average CFPS growth (%)	Price to CFPS rating	HGI (relative)	Analysts
1	CRESTON	Media	33.53	2250.0	2.1	40.9	4
2	CLARKSON	Industrial Transportation	165.44	331.5	7.5	20.5	3
3	NORTHGATE	Industrial Transportation	487.2	70.8	1.7	19.3	2
4	HUNTING	Oil Equipment & Services	850.85	72.1	12.4	14.2	7
5	EXPRO INTL.	Oil Equipment & Services	1002.01	51.3	9.9	12.7	8
6	CHARTER	Industrial Engineering	1108.55	7324.8	7.5	12.1	10
7	PARTYGAMING	Travel & Leisure	1090.47	3598.0	12.8	12.0	6
8	ABBOT GROUP	Oil Equipment & Services	884.17	47.3	11.0	10.5	5
9	CARE UK	Health Care Equipment & Services	236.29	373.6	5.8	9.2	6
10	LATCHWAYS	Support Services	92.37	1780.3	8.7	9.0	3
11	DTZ HOLDINGS	Real Estate	153.28	212.9	2.9	6.4	4
12	DANA PETROLEUM	Oil & Gas Producers	1116.89	775.1	5.8	4.2	11
13	MOTHERCARE	General Retailers	345.57	1142.8	8.3	4.1	11
14	CHEMRING GROUP	Aerospace & Defence	649.17	856.8	12.3	3.8	6
15	VENTURE PRODUCTION	Oil & Gas Producers	945.98	438.6	3.7	3.7	11
16	PENDRAGON	General Retailers	196.81	195.1	1.6	3.5	5
17	BURREN ENERGY	Oil & Gas Producers	1725.76	993.4	8.8	3.5	15
18	VISLINK	Technology Hardware & Equipment	54.03	193.7	3.2	3.3	3
19	GRAINGER	Real Estate	475.76	196.5	5.1	3.3	5
20	WHATMAN	Health Care Equipment & Services	328.55	298.5	13.0	3.3	4
21	HYDER CONSULTING	Support Services	154.53	1423.5	19.3	3.2	4
22	ROBERT WALTERS	Support Services	84.63	627.8	8.7	3.2	6
23	WSP GROUP	Support Services	292.66	557.8	8.2	3.0	10
24	WOLFSON MICROELECTRONICS	Technology Hardware & Equipment	180.96	409.0	8.0	2.8	12
25	KELLER	Construction & Materials	535	195.4	4.5	2.8	6
26	XAAR	Electronic & Electrical Equipment	91.14	2219.5	24.8	2.8	4
27	WINCANTON	Industrial Transportation	413.03	29.2	5.0	2.7	6
28	YELL GROUP	Media	2497.11	422.4	6.1	2.6	19
29	PHOENIX IT GROUP	Software & Computer Services	185.56	389.2	7.9	2.5	8
30	BRITISH AIRWAYS	Travel & Leisure	3608.78	160.1	2.7	2.5	23
31	JKX OIL & GAS	Oil & Gas Producers	606.89	638.4	8.1	2.5	8
32	CRANSWICK	Food Producers	359.9	65.4	9.5	2.4	4
33	BRITISH SKY BCAST.GROUP	Media	9307.59	618.7	10.0	2.3	27
34	VICTREX	Chemicals	526.71	114.0	10.4	2.2	9
35	NORTHGATE INFO.SLTN.	Software & Computer Services	541.68	370.4	8.7	2.2	9
36	CARPHONE WHSE.GP.	General Retailers	2737.18	441.6	6.0	2.2	22
37	PERSIMMON	House Builders	2372.66	105.8	3.8	2.2	11
38	MELROSE RESOURCES	Oil & Gas Producers	374.18	352.3	5.1	2.1	4
39	BARRATT DEVELOPMENTS	House Builders	1484.81	81.0	3.0	2.1	12
40	DIPLOMA	Support Services	191.09	106.9	2.2	2.1	4
41	SCI ENTERTAINMENT GP.	Software & Computer Services	53.21	46.6	1.2	2.1	6
42	SPEEDY HIRE	Support Services	352.57	146.2	3.1	2.1	10
43	MCBRIDE	Household Goods	178.44	27.8	3.6	2.0	5
44	ELEMENTIS	Chemicals	275.67	64.5	6.4	2.0	2
45	NATIONAL GRID	Gas, Water & Multiutilities	19648.64	56.4	6.6	2.0	18
46	WORKSPACE GROUP	Real Estate	475.44	269.8	11.7	2.0	6
47	AXON GROUP	Software & Computer Services	284.45	408.6	10.7	2.0	8
48	GALLIFORD TRY	Construction & Materials	279.61	143.3	4.8	1.9	7
49	DETICA GROUP	Software & Computer Services	248.77	355.5	9.6	1.9	12
50	COLT TELECOM GROUP	Fixed Line Telecommunications	1027.1	234.2	5.0	1.9	12
Average			**1,226.3**	**645.7**	**7.4**	**5.4**	**8.5**

Table based on that published in The Sunday Times, 3 February 2008

Key findings

Our definition of a Hidden Gem is a company whose cash flow per share growth is greater than the market but whose price to cash flow rating is lower; ie a company which should be more highly rated given its cash generation and the multiple which the stock market places on such growth.

Comparing the results for the 2007/8 Top 50 and the qualifying group, we find that the Top 50's cash flow per share growth is over three times that of the qualifying group but whose price to cash flow rating is some 42% lower than the wider market.

The 'qualifying' group of 245 companies includes 57 listed within the FTSE 100, up from 51 in 2006, and only 45 companies within the FTSE 250. Unlike previous years, the index shows a greater balance between 'large caps' – defined as those within the FTSE 100 and FTSE 250 – and the remainder of the market.

There are four FTSE 100 companies within the 2007/8 Top 50 compared with 10 in 2006 and just five in 2005. Only 18 companies in the 2006 Hidden Gems Index re-appear in 2007/8.

The average market capitalisation for the 2007/8 Top 50 is £1.2 billion compared to £3.0 billion in 2006 and £1.3 billion in 2005.

2007/8 Top 50 Hidden Gems show an average rate of cash-flow-per-share growth of 645% compared to 620% in 2006 and 183% in 2005. The cash-flow-per-share growth within the Top 50 is almost 3.5 times that of the qualifying group which shows an average figure of 199%. *

Share price/CFPS

	2005	2006	2007/08
Top 50 multiple	8.9	11.1	7.4
Qualifying group multiple	15	15.6	12.7

The leading cash generative sector within the Top 50 this year, (six companies) proved to be **support services**. This was followed by **oil & gas** and **software & computer services** (five companies each). In most cases, these companies' position within the Top 50 is a reflection of an apparent 'glass ceiling' for ratings and share prices – that is, that there is a case for diminishing returns between forecast growth and share price performance.

Taking the analysis as a whole, the sector grouping with the greater proportion of the available companies within the analysis is UK **house builders**. While this may appear counter intuitive, as share prices in this area have collapsed ahead of an expected housing slowdown, it is generally accepted that these companies tend to generate more cash into a downturn, as land is sold and costs reduced, than through more buoyant periods when house builders are typically highly acquisitive. According to commentators, there is unlikely to be a better test of this theory than the expected market in 2008.

* The time periods involved here are:
1. Average of CFPS from 2005-2009 compared to the reported figure for 2004 (2007/8 HGI)
2. Average of CFPS from 2004-2008 compared to the reported figure for 2003 (2006 HGI)
3. Average of CFPS from 2003-2007 compared to the reported figure for 2002 (2005 HGI)

Business challenges?

Cash flow becoming more important?

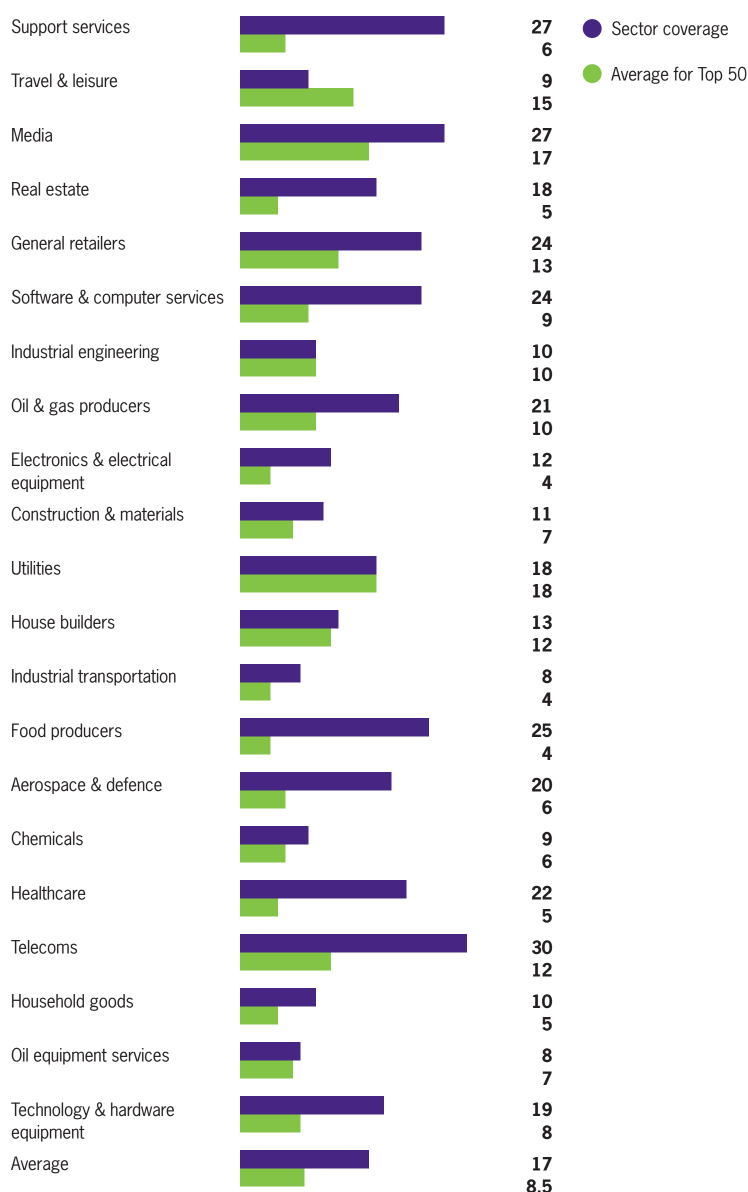
The first half of 2007 was characterised by continued buoyancy in share prices and speculation over further corporate activity. As the analysis highlighted at the time, ongoing values were principally determined in reference to earnings and assets while bids were often based on cash flow modelling over the medium term. This mismatch led to a two-tier market whereby companies deemed too small, illiquid or simply unfashionable to be bid for, languished on earnings-derived ratings while the more obvious bid candidates traded at substantial premiums.

With market conditions changing for the worse, cash flow strength is likely to be far more central to investor considerations. Market signs are clearly pointing at even more bearish conditions with a focus on the prospect of broken debt covenants for the first time in at least five years. Cash flow – represented by consistent cash generation, low gearing or both – is likely to be more important as a determinant of equity value than for some time.

Analyst coverage: the key to value recognition?

Throughout the life of the Hidden Gems analysis, we have consistently claimed that analyst coverage is a component factor in determining the value of a company's equity. While underlying fundamentals and the visibility of future earnings and cash flow are paramount, the degree of impact they have on a share price could be determined by the scale of analyst coverage.

There are 21 different sectors represented in the HGI Top 50 in 2007/8 covered by an average of 17 analysts. The Top 50 Hidden Gems attract only half of the available analyst coverage.



Moreover, this average is slightly misleading when one considers that the Top 50 includes companies such as British Airways, British Sky Broadcasting Group, National Grid and Yell Group, where almost all the analysts in their sectors cover these shares. This analyst coverage bias in a sector may count against a full valuation.

Finally, in terms of statistical analysis, there is a very strong positive correlation between market capitalisation and the number of analysts, and that analyst coverage is determined by the free float within a company which, in turn, is a often a function of market capitalisation.

The Hidden Gems analysis appears to support the contention that analyst coverage is important in terms of capturing market value. However, it is important to recognise that it is only one component of value creation. Positive comment from analysts is more likely to come for a company whose financial model is clear, whose strategy is well explained and whose prospects are visible.

The 'glass ceiling'?

HGI analysis strongly suggests that, regardless of the quality of a company's financial communications efforts, it may not receive the rating that its cash flow warrants. While financial performance is the key to a stock market rating, the development of a relevant level is constrained by factors such as the sector classification, the relative size of the company within that grouping and the free float within the shares in issue. These factors often reduce in significance when the company itself is subject to a bid. Our research has long supported the view that there is an ongoing 'equity market value' and another, higher value when the company is under bid. Northgate Information Solutions is a good example of this situation.

Case study: Northgate Information Solutions

Northgate Information Solutions (NIS) is an archetypal Hidden Gem. It is ranked 35th this year and has featured in almost every analysis since 2001. NIS had recently suffered at the hands of the equity market because of its high net debt to asset ratio, itself a function of an acquisition. While the company reported strong interim results in December 2007, with operating profit up by 23%, the shares were marked lower on debt concerns. Indeed, analysts reduced recommendations on speculation that the company could be in danger of breaching its debt covenants; a rumour NIS subsequently denied on announcing a bid approach. The shares actually fell to a four-year low before NIS was able to announce that KKR (Kohlberg, Kravis, Roberts) had agreed to acquire the company for 95p per share, over 100% above the share price's low which was reached less than a month before.

As was the case with McCarthy and Stone – our case study in the 2006 report – the market was at a loss to explain the basis for this bid for NIS. The highest, most optimistic, price put forward by analysts for the company was 65p and most commentators highlighted the potential for the level of debt to constrain the company's progress despite reasonable operational cash flow as evidenced by its operating profit performance. This is another reminder to companies that explaining the cash flow dynamics of their businesses could lead to more accurate valuations from the equity market. This year, perhaps more than any other in the last five years, the analysis suggests that providing detail and information on cash flow will assist the market in valuing companies appropriately.

Top executives highlight their company's approach to influencing value

Paul Humphreys
Group Finance Director

Paul Humphreys, Group Finance Director, is interested in his company being rated 9th in the latest Hidden Gems Index. Founded in 1994, Care UK is an independent provider of person-centred health and social care to a broad spectrum of service users throughout England and Scotland. The business is providing care for more than 20,000 people at any given time in over 100 care homes, through more than 40 community-based homecare locations and in primary and secondary care centres.

"You could say that any business should never be a hidden gem! In Care UK's case there are logical reasons at the moment why our share price is not reflective of our market performance. With over 96% of our revenue currently coming from the public sector, tied to government contracts of various types, some investors and analysts might overlook the strength of Care UK's strategic positioning. The healthcare market is an emerging one and share ratings of providers in this market can fluctuate markedly on the basis of short-term contract acquisition issues."

"We have spent a lot of time over the past five years getting key stakeholders closer to our story; we have a broader service offering than most other providers so we need to ensure that there is buy in to our longer term strategy. We want the investor and analyst communities to understand that there is much more behind our numbers. Those specifically interested in our sector will usually be more aware of its dynamics. The direction of policy in the health and social care arena is towards patients being given greater individual choice and influence over the delivery of their care."

"As a business we differentiate our approach by listening carefully to what our customer needs and see ourselves as solution-providers rather than purely service sellers."

"Over a year, Mike Parish, our CEO, and I spend at least 10% of our time meeting the investor and analyst communities. At results time this can be a 10-day block of time. In my role it is important to understand the models being created and used by analysts, ensuring that they have the right information to be able to portray an accurate picture of our business. We are constantly aware of the importance of communicating our strategy to key stakeholders and to our employees. We also engage with the investor market whether our news flow is positive or negative – if the news is difficult it is even more important to communicate. An increasing number of sector analysts are beginning to focus on us as we develop this position."

George Stinnes
Group Treasurer & Head of IR

Ex-pilot and City corporate financier, George Stinnes, now Group Treasurer & Head of Investor Relations at BA, is sure that the company is well positioned for the long term. Spending around half of his time, and at least two days a week out of the office, on IR, he explains that BA's overall objectives are: "To maximise return from our capital, principally the aircraft fleet committed to the business, and to commit capital to fleet expansion or other projects only if the return on investment exceeds our long term cost of capital. We spent the last five years driving margin, improving asset productivity and restructuring our pension fund."

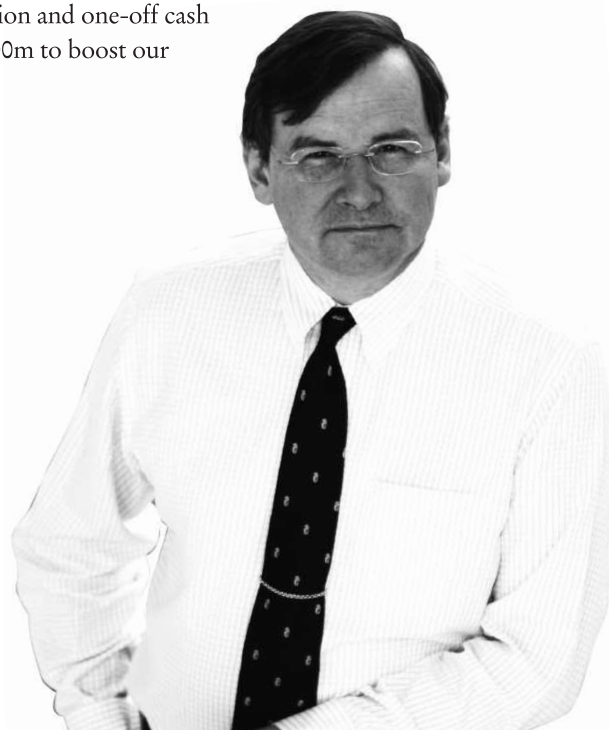
The company's cash flow and forecast is strong and BA is now at an inflexion point as it considers its strategic options. "Firstly, BA is seeking organic growth where more slots and new routes may yield appropriate returns, although I am very aware that slot pairs at Heathrow have recently traded at around $50 million; secondly we are also reviewing global consolidation where economic, profitable growth may lie; finally we benchmark these options against a low growth strategy which is also possible to follow."

Looking at how BA influences its market value, George is confident about BA's market position. "BA's key competitive advantage is having their hub in London, arguably the best catchment area in the world with the best traveller mix. Terminal 5, solely for BA traffic, comes on stream towards the end of March 2008 and other milestones are now allowing BA to shift gears, as the business is strong and robust in readiness for the next upturn in the cycle."

"Our KPIs aim to focus the business on achieving a 10% operating margin through the cycle combined with an asset turn of approximately 1. We define value as earning more than our cost of capital and our compensation plans reflect this, with all staff focused on understanding how they can influence margins, with bonuses linked to operational performance measures. Senior management also have a long term incentive plan which targets BA's relative share performance against a basket of other listed airlines."

When considering the importance of its sector, George comments: "Although BA is placed in the FTSE Travel & Leisure sector, which includes many companies other than airlines, we prefer to focus on buy and sell side analysts who specifically cover global airlines."

Noting that BA has slipped down to 30th in this year's the Hidden Gems Index compared with 8th in 2005 and 12th in 2006, George explains why: "Our cash generation was affected in the past few years by a one-off settlement under a competition investigation and one-off cash injections totalling £800m to boost our pension fund."



Don Elgie
CEO

Creston Plc is the top Hidden Gem this year and Don Elgie is the CEO. Creston is a diversified marketing services group that he formed in 2001, with blue chip clients including General Motors, HBOS, Nissan, Sainsburys, AstraZeneca, Glaxo Smith Kline, Toshiba, Royal Mail. Creston has a history of strong organic growth and earnings-enhancing acquisitions. This includes a number of brand leaders in their fields like DLKW, ICM and TMW covering digital marketing, CRM, PR, direct marketing and healthcare.

Don says, "There is currently a complete disconnect between our strong operational performance and our share price, as identified by Hidden Gems. We have a very loyal institutional investor following but, being a small cap stock, the share price can be negatively affected by relatively small retail trades.

We need to continue to explain that our diversified model should hold up well in any economic downturn. It's our job to make sure investors understand the resilience of our model.

Around 85% of our revenue is contracted/repeat which gives us strong visibility compared to most of our peers."

Mike Foster
CEO

"We believe we are well positioned to continue to generate value for shareholders." says Mike Foster. "Charter's two businesses, ESAB and Howden, are operationally separate but have important characteristics in common. Both have established market-leading positions in the supply of components to end-users which, while performance-critical, represent only a small proportion of the total cost of the finished item. We have built upon the strength of each business's brand, particularly through investment in product development and customer relationships, and taken great care to retain each business's unique heritage. We have increasingly moved manufacturing to low-cost locations, including through the use of sub-contractors. We have diversified the customer base of each business away from their traditional areas of strength in Europe, so that both are now genuinely international, deriving around half of their sales in developed markets and the remaining half in the faster growing emerging markets of Asia, South America and South Africa. We have also invested in communication, both in the way the businesses communicate within themselves and the way we as a company communicate with shareholders and the investment community generally."

Bruce Thompson
CEO

DIPLOMA PLC

"We firmly believe that value is created for shareholders by consistently delivering strong, stable earnings growth and robust free cash flow." says Bruce Thompson.

"At Diploma, we invest in specialised distribution businesses with long-term growth potential. We focus on supplying high quality products and services to specialised technical sectors including Defence, Aerospace, Motorsport, Healthcare and Environmental. Our businesses are resilient and deliver growth across the business cycle since a high proportion of revenues are generated from consumable product sales and service contracts which are driven by the customers' operating budgets rather than their capital budgets. Our operating margins are ca. 15% and remain stable over time as our businesses supply differentiated products supported by a high level of customer service, strong technical support and value adding activities.

Over the last five years, Group revenues have grown at an average of 15% p.a. and earnings by 20% p.a. This growth has been achieved through a balanced combination of organic growth and carefully selected acquisitions. Free cash flow over the same period has been consistently strong, representing around 90% of after tax profits.

We believe that if we continue to deliver this strong growth in earnings and cash flow and continue to promote the attractive characteristics of our businesses, then the market will recognise the true value of the Group."

Andrew Cunningham
Deputy Chief Executive and Finance Director

grainger plc

"Grainger is unusual amongst listed real estate companies in that our major source of income comes from the trading of residential property which we often hold for many years before sale." says Andrew Cunningham. "We therefore have no real peers in the UK listed sector and analysts find it difficult to judge comparative performance. This can mean that our share price is subject to changes and sentiment which are not directly applicable to our own performance.

Our challenge therefore is to educate both analysts and investors with the Grainger business model and in particular the advantages that come from our strong cash flow, unique portfolio and underlying management capabilities. We present alternative value measures to other real estate companies which we believe more accurately represent the underlying worth of the business.

We also take time and care to present our strategic aims and objectives and how they will deliver long-term returns to our shareholders, even when there may be short-term turbulence in the residential market."

Steve Lucas
Finance Director

nationalgrid

"Our core business is the moving of electricity and gas and we have a huge presence in both the UK and the US", says Steve Lucas. "Worldwide, some $10 trillion of investment is required over the next 20 years in the energy utility space – the need to upgrade networks and climate change are just a couple of drivers. We are superbly positioned to take advantage of this growth opportunity and our own plans include investment of £16 billion by 2012, driving huge growth in our asset base. 95% of our business is regulated – this underpins our investments and gives good predictability of revenues and cash flows. For a utility, we have a unique operating model through which we manage common activities and processes on a global basis, delivering benefits through standardisation and by leveraging our scale. I believe these features of our business deserve a premium rating – particularly in today's volatile markets. When you consider that all this comes with targeted dividend growth of 15% this year and then 8% per year until 2012, National Grid delivers a very attractive investment proposition."

Steve Corcoran
Chief Executive

"Speedy Hire has delivered compound annual revenue growth in excess of 23% for the past 10 years", says Steve Corcoran. "Importantly this growth has not been delivered by sacrificing either operating margins or our return on capital; these have remained broadly stable throughout this period at 14% and 17% respectively. Our growth is driven through the re-investment of the cash we generate. As a broad rule of thumb approximately one third of our revenue has historically been turned into cash, and we use this to replace and enhance our assets for hire.

We remain confident of delivering further growth because the case for hire over ownership is a compelling one. This is particularly the case when you consider the operating and financial costs involved with owning, servicing and distributing an in-house fleet. These costs, when associated with the flexibility that hire provides, have driven a culture of hire over ownership. Combined with the moves toward outsourcing, this presents clear growth potential and growth is further enhanced with the increasing regulatory environment in which construction operates.

Through our industry-leading investment in new equipment Speedy Hire operates the most modern fleet available, accompanied with the most highly developed network and the widest range of products available. We are therefore best placed to support increasing customer demand and to meet the changing market dynamics."

Graeme McFaull
Chief Executive

Wincanton designs and delivers advanced supply chain solutions through warehousing, transport and distribution, supply chain consultancy and reverse logistics.

"Since our demerger in 2001, we have demonstrated strong levels of organic growth combined with sensibly-priced acquisitions that have been well integrated", says Graeme McFaull. "Our business model is generating growth and value, and we have expanded our activities along the supply chain as well as entered new market sectors.

As the logistics market grows and consolidates, we are strategically well placed to benefit from greater investment due to our strong customer portfolio, diversified service offering and balanced geographic footprint. The combination of continued growth in our UK business, increasing returns in Mainland Europe and the further expansion of our portfolio of services, sectors and geographies, both organically and through acquisition, gives us confidence that we can continue to deliver the double-digit percentage profit growth that we have reported over recent years.

Good levels of customer retention and contract lengths up to 10 years will help insulate the business if the UK economy continues to slow. We are targeting a significant improvement in profitability in our Mainland European operations."

Malcolm Paul
CFO

"The WSP Group has grown dramatically over the last five years and received strong investor support with a growing share price." says Malcolm Paul. "Changes in the perception of underlying economic circumstances in the Autumn of 2007 have had a dramatic impact on the share price with a fall of more than 60%, while the company's financial performance has been unaffected.

The fundamental reasons are that the group provides professional services to the Property, Transport and Environmental markets all around the world and concern exists that these markets will be effected by the credit crunch in the banking world.

However, what is not appreciated or understood is how diverse WSP is across a broad spread of regions, sectors and skills. For example, work in the Middle East or in the public sector remains very strong and we see no sign of any material impact on our overall performance. Once this is understood by institutions, we believe it will be reflected in an improving share price."

Sector analysis and trends

Sector	HGI Rank	Company	Market capitalisation	Average CFPS growth (%)	Price to CFPS rating	HGI (relative)	Analysts
Construction	25	KELLER	535	195.4	4.5	2.8	6
Construction	48	GALLIFORD TRY	280	143.3	4.8	1.9	7
Construction	70	MORGAN SINDALL	965	140.4	7.1	1.3	8
Construction	95	KIER GROUP	450	77.5	5.7	0.9	10
Construction	104	ROK	99	75.4	6.2	0.8	5
Construction	156	BALFOUR BEATTY	(13)	45.7	9.3	0.3	11
Construction	223	MARSHALLS	343	6.1	6.3	0.1	10
Average			**379.9**	**97.7**	**6.3**		**8**
House Builders	37	PERSIMMON	2,373	105.8	3.8	2.2	11
House Builders	39	BARRATT DEVELOPMENTS	1,485	81.0	3.0	2.1	12
House Builders	60	BELLWAY	944	77.9	4.4	1.4	12
House Builders	68	TAYLOR WIMPEY	1,935	51.9	3.2	1.3	8
House Builders	74	REDROW	464	59.8	3.9	1.2	13
House Builders	165	BOVIS HOMES GROUP	741	23.4	6.6	0.3	10
House Builders	180	BERKELEY GP.HDG.UNITS	1,181	21.5	7.9	0.2	9
Average			**1,303.3**	**60.2**	**4.7**		**11**
Media	1	CRESTON	34	2250.0	2.1	40.9	4
Media	28	YELL GROUP	2,497	422.4	6.1	2.6	19
Media	33	BRITISH SKY BCAST.GROUP	9,308	618.7	10.0	2.3	27
Media	65	ENTERTAINMENT RIGHTS	61	84.6	2.4	1.3	4
Media	84	UNITED BUSINESS MEDIA	1,304	230.3	8.4	1.0	14
Media	122	REED ELSEVIER	6,777	201.4	12.4	0.6	19
Media	137	ITE GROUP	348	150.0	12.5	0.5	6
Media	157	AEGIS GROUP	1,211	77.6	9.3	0.3	16
Media	168	TAYLOR NELSON SOFRES	696	50.3	7.0	0.3	14
Media	171	WPP GROUP	7,021	58.7	8.8	0.3	22
Media	175	INFORMA	1,631	55.8	8.8	0.2	14
Media	181	EUROMONEY INSTL.INVESTOR	402	46.8	8.7	0.2	7
Media	184	DAILY MAIL ‘A’	1,729	28.4	5.8	0.2	12
Media	185	PEARSON	5,394	44.2	10.0	0.2	15
Media	197	REUTERS GROUP	7,575	50.1	13.9	0.1	10
Media	198	EMAP	1,972	44.2	12.4	0.1	15
Media	199	JOHNSTON PRESS	710	19.8	5.6	0.1	12
Media	215	BLOOMSBURY PBL.	118	34.0	15.4	0.1	7
Media	228	SMG	143	3.4	2.8	0.0	5
Media	239	TRINITY MIRROR	920	2.0	6.1	0.0	15
Average			**2,492.5**	**223.6**	**8.4**		**13**

Comparative information about qualifying companies with insights from Grant Thornton sector specialists.

Construction and Materials

This sector has seen considerable change during the period of HGI analyses. At the turn of the century, there was a trend for pure construction companies such as Amey, Jarvis and WS Atkins to move into facilities management and seek re-classification within the Support Services sector. Latterly, construction companies have gone through a period of consolidation with the acquisition of Mowlem by Carillion the latest in a round of corporate activity. The materials component of this sector – once classified in its own right – has seen a significant reduction in the number of companies including Aggregate Industries, BPB, Hanson, Pilkington and RMC falling prey to foreign bidders. Those companies that remain, while featuring within the HGI analysis, do not rank as highly as other sectors. Only 47% of the available group of 15 companies qualify for the analysis and only two (Galliford Try and Keller) appear within the Top 50. The analysis highlights that this position is a function of slower than average cash flow per share growth.

Kathryn Hiddleston, Partner, comments: "Mainstream construction companies do not tend to go to the market because they have never been well received. Companies in this sector tend to have very low margins and suffer disproportionately when there are downturns in the economy and, as such, they are not generally perceived as attractive investments. However the experienced investor may be interested by these results as financial accounts for construction companies can be confusing because the vagaries of valuing work in progress and retentions – cash flow forecasting obviously takes away this uncertainty.

Of the two companies highlighted as hidden gems – Keller's turnover was up 11% to December 2007 and seems to be going from strength to strength however it is not clouded with current UK economic concerns as less than 10% of its order book is home grown. Whilst Galliford Try's figures have been consistently bolstered by its housing arm and as such it is questionable whether it should reside in this sector analysis."

House Builders

House Builders have consistently featured within the Hidden Gems analysis. In part, this is due to the market's view of the quality and visibility of cash flow within this sector. While house prices are rising, inflation gains are accorded relatively low multiples on a 'low quality' basis. When the market weakens, as is apparently the case now, the 'gearing' impact of static or falling prices on fixed cost bases (notably in terms of land cost) substantially reduces forecasts and, therefore, share prices. However, this ignores the fact that, during periods of market weakness, house builders typically restrain land buying which, as the largest component of cash uses, allows cash flow to improve.

While earnings growth may stall, the quality house builder uses market weakness as a means of reinforcing the balance sheet. All of the house builders listed in the FTSE All Share qualify as Hidden Gems, an unprecedented feat. Although only two appear in the Top 50, and cash flow per share growth is modest at 60% compared to 199% for the qualifying group, the de-rating of the sector produces the lowest price to cash flow per share rating in our analysis at just 4.3x. Given the market they face in 2008, any cash flow growth is pleasantly surprising. This sector is a strong example of how wider macro-economic sentiment can obscure the underlying fundamentals of the sector and of individual companies.

"Unfortunately the housing sector tends to be 'tarred with the same brush' as mainstream construction." says Partner, Kathryn Hiddleston. It is true that house building may be somewhat in the doldrums at the moment with builders starting fewer homes in 2007 than at any time in the previous four years; however this should only be a short term phenomenon as house building remains strongly on the Government agenda.

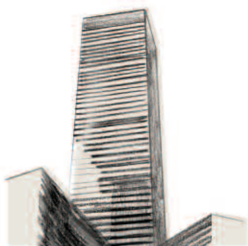
Media

Almost two thirds of Media constituents qualify for the analysis. Although of these 20 companies, only three make it to the Top 50, it represents the largest single grouping of companies behind Support Services and Travel & Leisure. Like Software, this position is driven by above average cash-flow-per-share growth (224% compared to 199% for the analysis). Unlike Software, this position is compounded by a low price-to-cash-flow-per-share ratio (8.3x compared to 12.7x for the analysis). While Creston (ranked number 1 in 2007/8 HGI) stands out, there are others who have clearly suffered at the hands of a broad brush approach to valuation taken by the market.

Mark Henshaw, Partner, Media Team, comments: "The results of the analysis are no surprise. In a diverse sector which encompasses everything from TV production to conferences, the dominant players tend to be businesses that provide business to consumer services and provide a halo over the sector as a whole. They grab the headlines and drive overall market sentiment. B2B, however, remains a strong bet where consolidation is a key driver. That the market does not reflect this strength in their share price is a factor of the halo effect."

Sector analysis and trends continued

Sector	HGI Rank	Company	Market capitalisation	Average CFPS growth (%)	Price to CFPS rating	HGI (relative)	Analysts
Real Estate	11	DTZ HOLDINGS	153	212.9	2.9	6.4	4
Real Estate	19	GRAINGER	476	196.5	5.1	3.3	5
Real Estate	46	WORKSPACE GROUP	475	269.8	11.7	2.0	6
Real Estate	57	CLS HOLDINGS	231	86.4	4.6	1.6	1
Real Estate	64	SHAFTESBURY	700	221.9	14.4	1.3	4
Real Estate	77	BRITISH LAND	5,184	200.6	15.3	1.1	13
Real Estate	80	DEVELOPMENT SECS.	187	92.1	7.2	1.1	2
Real Estate	82	SAVILLS	384	64.4	5.1	1.1	6
Real Estate	86	WARNER ESTATE	189	71.1	6.3	1.0	3
Real Estate	87	LIBERTY INTL.	3,708	127.1	11.4	1.0	2
Real Estate	89	HELICAL BAR	349	71.0	6.6	0.9	2
Real Estate	98	ST MODWEN PROPS.	577	126.3	12.8	0.8	2
Real Estate	106	LAND SECURITIES	7,372	111.6	12.5	0.8	12
Real Estate	107	HAMMERSON	3,224	114.0	12.8	0.8	12
Real Estate	125	GREAT PORTLAND ESTATE	840	110.5	16.2	0.6	7
Real Estate	129	SEGRO	2,129	58.4	9.6	0.5	11
Real Estate	139	TOWN CENTRE SECURITIES	173	49.4	9.8	0.4	2
Real Estate	167	DERWENT LONDON	1,377	50.9	16.1	0.3	5
Real Estate	201	BRIXTON	916	20.3	13.5	0.1	8
Average			**1,507.6**	**118.7**	**10.2**		**5**
Retail	13	MOTHERCARE	345.6	1142.8	8.3	4.1	11
Retail	16	PENDRAGON	196.8	195.1	1.6	3.5	5
Retail	36	CARPHONE WHSE.GP.	2,737.2	441.6	6.0	2.2	22
Retail	54	WOOLWORTHS GROUP	140.1	103.3	1.7	1.8	9
Retail	56	TESCO	32,508.6	60.1	9.5	1.7	23
Retail	92	SCS UPHOLSTERY	17.3	37.6	1.2	0.9	6
Retail	97	GREGGS	4,275.0	23.4	7.4	0.9	6
Retail	110	MARKS & SPENCER GROUP	7,182.3	140.9	5.8	0.7	24
Retail	113	LOOKERS	149.7	118.2	5.1	0.7	6
Retail	120	TOPPS TILES	235.4	168.8	8.0	0.6	15
Retail	126	NEXT	2,703.2	112.2	5.8	0.6	24
Retail	140	MORRISON(WM)SPMKTS.	7,910.4	15.4	9.7	0.4	24
Retail	159	INCHCAPE	1,687.8	72.6	7.4	0.3	7
Retail	178	BURBERRY GROUP	1,730.4	81.3	10.9	0.2	13
Retail	186	TED BAKER	203.9	69.5	12.4	0.2	11
Retail	208	CARPETRIGHT	537.7	33.7	9.4	0.1	14
Retail	214	GAME GROUP	702.4	34.8	12.4	0.1	11
Retail	221	DSG INTERNATIONAL	1,364.8	8.3	3.6	0.1	23
Retail	237	SIGNET GROUP	1,070.2	4.7	7.8	0.0	14
Retail	244	FINDEL	453.6	1.8	33.8	0.0	7
Average			**3,307.6**	**143.3**	**8.4**		**14**
Software	29	PHOENIX IT GROUP	186	389.2	7.9	2.5	8
Software	35	NORTHGATE INFO.SLTN.	542	370.4	8.7	2.2	9
Software	41	SCI ENTERTAINMENT GP.	53	46.6	1.2	2.1	6
Software	47	AXON GROUP	284	408.6	10.7	2.0	8
Software	49	DETICA GROUP	249	355.5	9.6	1.9	12
Software	75	DICOM GROUP	132	237.1	10.6	1.2	5
Software	96	RM	189	183.6	11.1	0.9	5
Software	105	INTEC TELECOM SYS.	118	150.8	10.1	0.8	3
Software	123	MICRO FOCUS INTL.	411	162.6	14.3	0.6	6
Software	138	AVEVA GROUP	622	161.7	19.1	0.4	8
Software	144	LOGICACMG	1,538	57.4	7.2	0.4	28
Software	162	SAGE GROUP	2,710	56.8	10.5	0.3	14
Software	187	FIDESSA GROUP	246	48.3	15.2	0.2	5
Average			**559.9**	**202.2**	**10.5**		**8**



Real Estate

In terms of the constituents of the FTSE All Share Index, Real Estate is one of the more populous sectors. Apart from the Support Services sector, it has more potential qualifying companies (40) than any other in the equity market. However, only 19 companies, or 48% of the available sector, qualify for the analysis while only three companies appear within the Top 50. To a great extent, this position reflects the fact that several qualifying companies generate average growth in CFPS but are awarded relatively high price-to-CFPS ratings. British Land, for example, records CFPS growth of 200% – just above the average for the analysis – but its share price is 14.1x forecast CFPS. This situation is equally true of smaller companies such as Derwent London, Great Portland Estates and Shaftesbury. While others within the analysis reduce the average rating for the group (to 10.0x or a 22% discount to the average for the qualifying group), the rate of CFPS growth is also at a discount to the wider HGI. We are aware that share prices have been weak in this sector as a function of the market's increasingly bearish view on property development but, from our analysis, this weakness appears to have already been reflected in cash flow growth forecasts.

Clare Hartnell, Partner, Real Estate, comments: "Cash flows in the Real Estate sector are normally well understood – rental income is secured and is predictable. With the recent credit squeeze, there is always a risk of a tenant defaulting but normally real estate investors have diversified this risk by having a number of different tenants for their properties. Cash flows are becoming even more important given the number of businesses in the sector that have converted to become Real Estate Investment Trusts (REITs) as they are obliged to follow a strict distribution policy, paying up 90% of their profits to shareholders. Property developers on the other hand are less understood – with their cash flows generally being lumpier, dependant on progress with developments."

Retail

For the purposes of this report, we have combined Food and General Retailers into one group. There are 43 retailers listed within the FTSE All Share Index, the largest grouping in our analysis. However, the 20 qualifying for the analysis (47%) is one of the lowest proportions within the analysis. This is due to the apparent lack of cash flow generation within general retailers, only 45% of which qualify. By contrast, 60% of food retailers qualify on the same basis. Only three general retailers and no food retailers appear in the Top 50.

Mothercare, which has appeared in several HGI analyses, is ranked 13th in the 2007/8 analysis. The company restructured considerably over the last few years and the benefits of this are starting to appear in reported figures and forecasts. Notwithstanding this growth, the price to CFPS rating at 8.3x is at a considerable discount to the wider analysis. The Carphone Warehouse, at 36th position, is another example of a retailer bucking the sector trend. Although its CFPS growth is slower than Mothercare's, its price-to-CFPS rating is also lower. The wider retailing group is a good example of how a sector can be relatively well valued but still contain Hidden Gems.

David Bush, Head of Retail, comments: "Most successful retailers are characterised by strong cash flow as the absence of a significant debtor book means that (in many cases) retailers are receiving money for goods from customers before they have even paid the supplier of that product. As this characteristic is understood and factored in by the market, we would expect to see relatively few instances of Hidden Gems in Retail. Our analysis bears this out."

Software

The experience of NIS highlights the sector issue which the Hidden Gems 2007/8 uncovers: that 'unfashionable' sectors can adversely impact individual companies' values. NIS is listed within a sector which, this year, has a strong showing within the analysis. Over half of the available sector constituents qualified for Hidden Gems with five of this group making it to the Top 50. The sector's cash flow growth, at over 200%, illustrates the apparent strength of the underlying fundamentals. Despite this, the sector has experienced an average share price fall over almost 25% within the last 12 months. Software and Computer Services companies have suffered from three key issues for the equity market; consumer facing, US exposure and high debt.

Sarika Patel, Partner and National Head of Technology, comments: "The Software and Computer Services sector has established itself as a mature industry and with changes in technology (software as a service, virtualisation etc) perhaps will be viewed as a utility in the future. The growth has been market-led and is demonstrated by the valuations reflected through the M&A activity. I expect that the M&A activity will continue in, and continue to define, the valuations, albeit adjusted for the slightly inflated 2007 multiples. Most companies like Sage are in a strong, and secure, market although appearing 'unfashionable'."

Conclusions

No short-term fix in sight

In today's turbulent environment, the stock market takes time to reward growth, but is quick to react on the slightest hint of bad news. Well-run companies with a clear strategy and strong operational cash flow deserve recognition – even if not in the FTSE.

The last six HGI studies highlighted a critical factor in the relationship between the corporate sector and the equity market. Companies are not simply valued on their fundamentals. Instead, issues such as the relative size of the company, the liquidity of its shares, sector classification and amount of analyst coverage all have an impact on its value. The market's recent rollercoaster ride is an example.

Mind the gap

Our analysis suggests that strong cash flow growth can be at odds with the equity market's valuation. While we are not able to differentiate between those companies whose cash flow forecasts lag reality and those whose share prices lag growth, we can state that five of the 10 companies from the 2006 analysis show a positive gain of over 25%. Against this, the FTSE All Share Index fell by almost 8% over the same period while the FTSE 100 declined by 6.5%.

Recent history suggests that such increases in value are driven by either predatory interest (which accounted for the gains in value within Burren Energy and NIS) or focused communication of the underlying fundamentals driving cash flow growth where companies such as John Menzies have clearly had success.

While interest cannot be guaranteed, profile is more likely to be raised when companies seek to play a more active part in the communication of information relevant to their share prices. Market research is essential, as is the construction of a relevant message.

Share price and strategic impact

Some may shrug their shoulders and wonder why it matters. Others realise that share price does affect their ability to use their paper for growth, be that for acquisitions, raising funds, managing bank funding, incentivising their people in rewards, morale of the staff – everyone feels good when the share price is strong – or simply defending against predators who seek to gain advantage at the expense of the shareholders. At Grant Thornton, we regularly work with clients on these areas and believe that they matter as part of a successful corporate strategy.

John Pierce, Chief Executive of The Quoted Companies Alliance, comments:

"Once again the Hidden Gems Index shows the importance for companies, especially smaller quoted companies, to identify **all** the positives they possess and to communicate these in a targeted way not just to shareholders but to the investment community and the market in general. With IFRS becoming evermore complex and users of accounts complaining of confusion and bewilderment, a strong cash flow shines like a 'beacon in the fog', so the message to companies seems to be – if you've got it, flaunt it!"

Peregrine Riviere, Chairman of the Investor Relations Society, and Group Director of Corporate Affairs at The Carphone Warehouse Group plc, comments:

"The Hidden Gems report highlights the importance of not just running your company well but also communicating your strategy and success effectively. And, when there is increased uncertainty in the market, it is ever more important to ensure that the market understands your strategy. A consistent and coherent investor relations programme is essential. By attempting to view yourselves as the market sees you, we believe that your communications will be more relevant and generate greater market confidence. With more confidence comes higher value."

Methodology: how the figures are calculated

The Hidden Gems Index (HGI) is generated from companies listed in the FTSE All-Share Index (the 'All-Share'). This is a total universe of 686 companies.

HGI excludes:

- 217 finance companies on the basis that their generation of cash flow differs fundamentally from other companies.
- Another 90 companies are excluded on the basis of insufficient data being available, typically because they have listed on the London Stock Exchange within the last four years.
- A further 16 companies within the All-Share have reported, or are expected to report, negative cash flow-per-share.
- Finally, 118 companies are showing negative cash flow share growth in either historic or forecast data.

This leaves 245 companies available for HGI analysis or 36% of the total universe.

Each qualifying company is awarded an HGI number. This is calculated by dividing the growth factor by the rating and then expressing this result relative to the relevant sector average. The growth factor is derived from the comparison of the six-year average annual cash flow per share over the period 2005 to 2010 with that reported in 2004. The rating is derived from the current share price divided by the average of forecast cash flow-per-share over the forecast time frame (ie a maximum of three years).

Cash flow comprises operating profit adjusted for depreciation and any amortisation of intangible goodwill, working capital flows, net interest on debt and taxes on profits. It excludes capital expenditure, dividends paid to ordinary shareholders or cash flow arising from acquisitions or disposals.

To ensure that the HGI better reflects the sector basis on which the investment community assesses companies, we continue to use a sector weighting within the analysis. Each company is quoted within its FTSE classification. The individual HGI numbers are then weighted according to each company's relative market capitalisation. The sum of these weighted figures gives us the sector HGI against which each company's individual HGI number is gauged.

The Top 50 comprises the highest 50 scores from the above calculation and, therefore, automatically takes account of differences in the average ratio of operational cash flow to share in different sectors.

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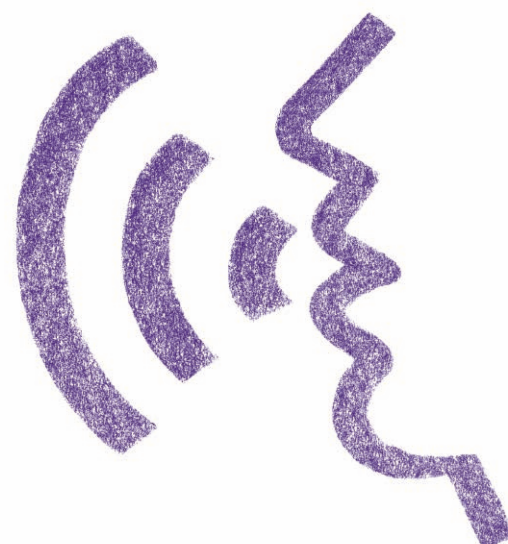

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